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IN THE

# Supreme Court of the United States

October Term, 1971

Supreme Court, U.S.
FILED
FEB 10 1972
E. ROBERT SEAVER, CLERK

No. 70-220

MORTIMER M. CAPLIN, Trustee in Reorganization of Webb & Knapp, Inc., etc.,

*Petitioner,*

v.

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

## BRIEF FOR THE PETITIONER

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## BRIEF FOR THE PETITIONER

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### Opinions Below

The opinions of the District Court (58a, 62a, 67a) have not been reported. The majority and dissenting opinions of the Court of Appeals, *in banc* (84a, 96a), are reported at 439 F.2d 118 (2d Cir. 1971).

### Jurisdiction

The judgment of the Court of Appeals (82a) was entered on March 3, 1971. The petition for a writ of certiorari was filed May 29, 1971, and was granted December 7, 1971. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

## Question Presented

Whether the trustee in reorganization of a debtor under Chapter X of the Bankruptcy Act is barred, as lacking standing, or not being the real party in interest, from bringing a suit or prosecuting a claim on behalf of the debtor's debenture holders against the indenture trustee for willful misconduct or gross negligence in failing to enforce covenants in the trust indenture.

## Statutes Involved

Relevant portions of the Bankruptcy Act and the Trust Indenture Act of 1939 are set forth in Appendix A, *infra*, pp. 35-39.

## Statement of the Case

Petitioner Mortimer M. Caplin, trustee in the bankruptcy reorganization of Webb & Knapp, Inc. (the "Debtor"), seeks damages on behalf of the Debtor's debenture holders from respondent indenture trustee, The Marine Midland Grace Trust Company of New York ("Marine"). Petitioner Caplin (the "Trustee") charges that the losses suffered by the debenture holders are attributable to Marine's willful misconduct or gross negligence. The District Court held that the Trustee has no standing to assert the claims of debenture holders against Marine and further that he is not the real party in interest. A divided Second Circuit, sitting *in banc*, affirmed. The Trustee seeks reversal of that order so that he can, on remand, litigate the merits of his charges against Marine.

The petition seeking the reorganization of the Debtor under Chapter X of the Bankruptcy Act was filed by

Marine itself on May 7, 1965. The Securities and Exchange Commission ("SEC") intervened on May 10, 1965. It has participated throughout and supports the Trustee in this action. The Trustee was appointed on May 18, 1965. Pursuant to sections 21a and 167 of the Bankruptcy Act, the Trustee intensively investigated all of the Debtor's affairs. He found that appraisals and certifications submitted annually by the Debtor to Marine were false and fraudulent.

These appraisals and certificates were crucial. Section 3.11 of the trust indenture (the "Indenture") (31a), required the Debtor to certify annually in writing to Marine that it had not defaulted under the Indenture. Marine, year after year, accepted the certifications and inflated appraisals without question, even after the occurrence of other defaults under the Indenture which should have alerted it to the Debtor's precarious condition (40a). Marine either knew that the appraisals were inflated and willfully disregarded them or was grossly negligent in failing to recognize their falsity.

The crucial nature of the appraisals and certificates is apparent from a reading of section 3.6 of the trust indenture, which prohibited the Debtor from purchasing real property or incurring additional indebtedness unless it maintained a ratio of assets to liabilities of 200% (31a). The Trustee claims that the appraisals of real assets which the Debtor submitted to Marine in order to demonstrate that it was maintaining the required ratio were false and fraudulent, as Marine knew or should have known. In fact, at no time between 1958 and 1965 did the Debtor maintain the required ratio, and its excessive overstatements of real assets were apparent on their face. For example, a parcel of land in Bronx County, New York, on

which no significant improvements were made, was appraised and reappraised as follows (34a-35a):

| Year | Net Book Value | Appraisal |
|---|---|---|
| 1957 | $2,885,000 | $15,000,000 |
| 1958 | 2,918,000 | 27,500,000 |
| 1959 | 4,182,000 | 64,000,000 |
| 1960 | 5,952,000 | 64,000,000 |
| 1963 | 4,168,000 | 91,530,000[1] |

These false appraisals, which Marine wrongfully did not question, lay at the core of the Debtor's collapse, for even with them it was barely able to show that the stipulated ratio was being maintained (33a):

| Year | Ratio |
|---|---|
| 1959 | 201.35% |
| 1960 | 216.88% |
| 1961 | 258.30% |
| 1962 | 206.90% |
| 1963 | 200.56% |

Moreover the Debtor affixed a note to the appraisals for the years commencing 1958 which stated that they represented the officers' "view as to what the properties could be sold for on a cash basis under favorable market conditions after their earning power shall have been clearly established" (37a). The Trustee contends that this footnote put Marine on notice that the appraisals did not comply with the Indenture and were inflated, and that Marine,

[1] The parcel was not included in the 1961 and 1962 appraisals because it had been conveyed to an affiliated corporation. In 1963 it was conveyed to another corporation in which the Debtor had an 80% interest. Thus the 1963 appraisal of $91,530,000 represents only 80% of the property interest shown on the 1960 appraisal (35a).

however, took no action to compel the Debtor to comply with the Indenture.

In short, the charge which the Trustee seeks an opportunity to litigate is that Marine's gross negligence or willful misconduct permitted the Debtor to continue for many years an unchecked and disastrous course of real property purchases and additional borrowings in hundreds of transactions involving tens of millions of dollars—a course which led inexorably to default on the debentures and bankruptcy.

With authorization from the Reorganization Court, the Trustee commenced a plenary action against Marine for $4,298,200, the face amount of the defaulted debentures, and filed objections and a counterclaim to the proof of claim submitted by Marine in the reorganization proceeding.[2] The District Court dismissed the Trustee's counterclaim and his complaint in the plenary action. The court also denied the Trustee's petition to direct an accounting by Marine, but denied Marine's motion to strike the Trustee's objection to Marine's proof of claim. The District Judge concluded that under the decision in *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943), the Trustee had no standing to sue and that *Clarke* had not been overruled by *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir. 1953), *cert. denied* 346 U.S. 835, as the Trustee had asserted.

Two of the three judges before whom oral argument was had in the Second Circuit would have reversed the District Court and permitted the Trustee to prosecute the claims against Marine, but, pursuant to its procedure,[3] the

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[2] With court authorization the Trustee also sued the Debtor's directors for waste and mismanagement. A favorable settlement of this suit has been reached and has been approved by the Reorganization Court.

[3] This is established practice in the Second Circuit where a three-judge panel would overrule a prior decision. *See, e.g., Indussa Corp.* v. *S. S. Ranborg*, 377 F.2d 200 (2d Cir. 1967).

Court of Appeals reviewed the appeal *in banc*, without hearing oral argument, and affirmed the District Court decision, two judges dissenting. Emphasizing that the Trustee was asserting rights of the debenture holders rather than of the bankrupt estate, the majority concluded that the Trustee's suit, even if successful, would not have a substantial effect on the plan of reorganization. Since the majority decided to reaffirm the rule of *Clarke*, that a reorganization trustee can only pursue claims which are "part of the property of the bankrupt or would affect the plan of reorganization," 137 F.2d at 800, it held that the Trustee lacked standing. Further, the majority found that the Trustee was not the real party in interest under Rule 17(a) of the Federal Rules of Civil Procedure, for "nothing in the statute allows him to collect any monies or other property not owed to or owned by the estate . . ." (93a)

Judge Kaufman, writing for himself and Judge Hays in dissent, argued that Judge Learned Hand, a vigorous dissenter in *Clarke*, had *sub silentio* overruled that decision in *Prudence-Bonds*. Judge Kaufman further stressed that a reorganization trustee does not lack standing to sue merely because his lawsuit would benefit some but not all of the creditors, and that any lawsuit substantially benefiting a significant class of creditors will inevitably affect the overall plan of reorganization. He pointed out that as a practical matter claims such as that asserted by the Trustee here may not be pursued adequately unless presented within the context of the reorganization.

The dissenters also asserted that the result of the majority decision was to frustrate two reforms central to the Chandler Act: to promote and disseminate information relevant to the Debtor and to involve the SEC as advisor to the reorganization, *i.e.*, that by the majority's imposition of inflexible criteria upon the bringing of actions and asserting of counterclaims as a part of the reorganization proceeding, the proper use of evidence obtained by the

reorganization trustee's investigations is frustrated, and its utilization under the supervision of the SEC is thwarted (101a-102a).

## Summary of Argument

The standing of a Chapter X trustee stems directly from the underlying purpose of the Chandler Act and the Trust Indenture Act of 1939. The Chandler Act was enacted primarily to protect public investors, and its chief innovations were the provisions for an independent trustee, to act as a representative of investors, and direct participation by the SEC. Recognizing the overwhelming difficulties faced by individual debt investors in protecting their own interests, the Trust Indenture Act provided that their interests should be overseen by indenture trustees, and imposed minimum standards of conduct for the performance of those duties.

When an indenture trustee is guilty of violating its fiduciary duties, with resulting injury to bondholders, the latter's rights under the Trust Indenture Act are not likely to be redressed unless they can act through a representative. The reorganization trustee is the only person who can be relied upon to uncover hidden wrongdoing and effectively prosecute claims. His possession of the debtor's records, his broad investigatory powers, his functioning under court supervision with SEC participation, uniquely qualify him to act for the large number of injured bondholders, who may well be impotent acting alone. Where there is such a compelling need to give effect to remedial legislation, a right of action is implied, as it has been with respect to other statutes which make up the federal securities laws.

The Court below erroneously reaffirmed *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943), which held

that a Chapter X trustee may sue an indenture trustee on behalf of debt investors only if the defendant improperly dealt with property of the debtor or if the claim would affect the plan of reorganization. *Clarke* imports into reorganization proceedings narrow notions of property law which unduly restrict the broad scope of reorganizations under the Bankruptcy Act. In so holding, the Court below refused to recognize its own liberalization of the powers of a Chapter X trustee in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir. 1953), *cert denied*, 346 U.S. 835 (1953). It rejected the salutary approach taken by the Third Circuit in *In re Solar Mfg. Corp.*, 200 F.2d 327 (3d Cir. 1952), *cert denied, sub. nom. Marine-Midland Trust Co.* v. *McGirl*, 345 940 (1953), which found, in the express statutory authority in Section 212 of the Bankruptcy Act, 11 U.S.C. § 612, to compel an accounting by an indenture trustee, the right of a Chapter X trustee to counterclaim to such an account.

The Court below erred in failing to recognize that even under *Clarke* a recovery by the Trustee in this case would affect the estate, for obtaining material benefits to an important class of creditors is central to reorganization. In assuming that Marine would simply subrogate to the rights of debenture holders in the event it paid damages to them, the Court below was wrong, and it failed to see that in the give-and-take of the Chapter X proceeding other benefits to the estate were possible.

In concluding that the Trustee is not a real party in interest under Rule 17(a) of the Federal Rules of Civil Procedure, as if it were an entirely different doctrine, the Court below failed to see that criteria for standing and real party in interest are essentially the same, and that Rule 17(a) was intended to be a liberalizing, not a restricting, device.

# ARGUMENT

## POINT I

**Chapter X of the Bankruptcy Act and the Trust Indenture Act confer standing upon a reorganization trustee to prosecute claims on behalf of the debtor's debenture holders based upon the indenture trustee's willful misconduct or gross negligence.**

### A. Under the Congressional Scheme Regulating Bankruptcy Reorganization Proceedings, the Reorganization Trustee Is Made the Representative of All Investors and Creditors and Is Vested with the Responsibility of Discovering and Enforcing All Claims Arising Out of the Reorganization.

Bankruptcy reorganization proceedings often involve hundreds of claims aggregating millions of dollars presented by a wide diversity of investors and creditors. To insure that all interests receive adequate protection, Congress invested the reorganization trustee with broad powers, to be exercised under the supervision of the court and with the guidance of the SEC, to investigate and enforce all claims of investors and creditors which relate to the reorganization proceedings.

Both Chapter X and the Trust Indenture Act of 1939 resulted from a major study of bankruptcy reorganization procedures made by the SEC at the direction of Congress. This study, and the multi-volume report which derived from it, focused primarily on the plight of public investors in bankruptcy proceedings and spotlighted the need for new means of protecting them. For example, Commissioner (now Justice) Douglas testified as follows:[4]

> "There is . . . widespread and national investor interest in these reorganization proceedings. Cer-

[4] Hearings Before the Committee of the Judiciary, House of Representatives, 75th Congress, 1st Session, on H.R. 6439 subsequently amended and reported as H.R. 8046, June 1-4, 8, 9, 1937, page 163.

tainly in the larger cases the securities are widely held. The holdings are small, and individual action by the security holders, to protect themselves, is, in many cases, out of the question. They either lack the funds, or the skill, the acumen or the initiative to take matters into their own hands. They are frequently without any adequate representation in the proceedings. Even should they desire to organize for mutual protection, they normally will find that the lists of their fellow security holders are not readily available. They are at the mercy of the inside groups—the management and the investment bankers. And the records show that these inside groups frequently have objectives which are incompatible with the objectives of investors. They are interested in concealing claims for fraud or mismanagement; investors are interested in collecting on those claims. . . . The new system which is needed must afford not only a shield but a sword for bona fide investors and their representatives."

Three principal remedies were chosen by Congress. In passing the Chandler Act, which enacted Chapter X, Congress took steps to protect public investors by providing for the participation of the SEC at every stage of reorganization proceedings. See sections 161, 167, 171-174, 179, 190, 208, 222 & 265, 11 U.S.C. §§ 561, 567, 571-574, 579, 590, 608 622 & 665.

More than this was necessary, however, in order to insure that investor's rights would be vigorously defended and enforced, as the House Report on the Chandler Act made clear:[5]

> "It would be idle to provide that protective measures be adopted without likewise providing the means whereby such protection can be afforded. It would be futile to attempt to return these bankrupt estates to their real owners without providing the mechanism whereby the real owners could come into

[5] H. Rep. 1409, 75th Cong., 1st Sess. (1937), 43-44 (emphasis added).

> possession and power. *There must be power and responsibility in the hands of a qualified representative of investors.* Otherwise disorganization may result. *Investors must be afforded a 'focal point' for organization. Such a device as the independent trustee furnishes them with one* in the cases big enough to possess an appreciable investor interest."

In short the Chandler Act not only recognized the need to protect public investors by insuring the participation of the SEC in reorganization proceedings, but took the further, basic step of making the reorganization trustee responsible for actively pursuing their interests. In the words of the Report, the reorganization trustee is to be the "representative of investors." In the words of the Third Circuit, "Congress was determined that the trustee protect the interests of investors as well as those of general unsecured creditors." *In re Solar Mfg. Corp.*, 200 F.2d 327, 333 (3rd Cir. 1952), *cert. denied sub. nom. Marine Midland Trust Co.* v. *McGirl*, 345 U.S. 940 (1953). The purpose of Chapter X is perhaps best summarized in the words of this Court in *SEC* v. *American Trailer Rentals Co.*, 379 U.S. 594, 604 (1965):

> "The aims of Chapter X . . . were to afford greater protection to creditors and stockholders by providing greater judicial control over the entire proceedings and impartial and expert administrative assistance in corporate reorganizations through appointment of a disinterested trustee and the active participation of the SEC."

See also *SEC* v. *United States Realty & Improvement Co.*, 310 U.S. 434, 448-450 (1940); *General Stores Corp.* v. *Shlensky*, 350 U.S. 462, 466-467 (1956).

One year after passing the Chandler Act, the Congress adopted a third remedy designed to protect public investors. By passage of the Trust Indenture Act of 1939, Congress sought to protect investors by imposing minimum fiduciary duties on indenture trustees. Prior to this enact-

ment the protective clauses of trust indentures often proved to be illusory safeguards which merely permitted indenture trustees to immunize themselves from liability for blatant wrongdoing. A classic example is provided by *Hazzard* v. *Chase National Bank*, 159 Misc. 57, 287 N.Y.S. 541 (1936), *aff'd* 257 App. Div. 950, 14 N.Y.S. 2d 147 (1st Dept. 1939), *aff'd* 282 N.Y. 652 (1940), 26 N.E. 2d 801, *cert. denied* 311 U.S. 708 (1940). See generally 2 Loss, Securities Regulation 719-725 (2d ed. 1961). In *Hazzard* the indenture trustee had permitted new securities, valued under false certificates, to be substituted for the collateral which secured the debtor's debentures. Despite proof of this glaring malfeasance, the court was forced by the broad exculpatory provisions of the trust indenture to hold that the indenture trustee was free of liability. Judge Rosenman took the opportunity, however, to point out that the typical corporate indenture "trustee" had few real fiduciary duties and often occupied a position inconsistent with a genuine trust relationship:

> "It is becoming increasingly clear that these indentures, though legally permissible, have all the potentialities of fraud upon innocent investors. A recent study by the Legislature of the State of New York has revealed how widespread has been the damage caused to investors by such debentures . . . and how impossible it has been to secure relief in the courts. . . . This indenture was particularly vicious." 287 N.Y.S. at 570.

It was to remedy these and other abuses that Congress enacted the Trust Indenture Act of 1939. The Act itself recognizes that the "national public interest" requires that there be an indenture trustee for debt securities because individual action by bondholders

> "is rendered impracticable by reason of the disproportionate expense of taking such action, and . . . concerted action by such investors is impeded by reason of the wide disperson of such investors

> through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors." 15 U.S.C. § 77bbb(a)(1).

The statute expressly notes that the provisions of trust indentures generally relieve trustees of liability for negligent acts or omissions. 15 U.S.C. § 77bbb(a)(2).

To deal with these problems the Act provides that all publicly-sold debt securities must be issued pursuant to trust indentures and prohibits the exculpation of an indenture trustee "from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct." 15 U.S.C. § 77ooo(d).

In sum, Congress adopted three remedies to protect public investors: (1) it provided in the Chandler Act that the public interest would be represented by the SEC in all significant bankruptcy reorganizations, (2) it provided in the Chandler Act that the trustee in reorganization should actively represent the interests of investors as well as creditors, and (3) it provided in the Trust Indenture Act that the interests of purchasers of publicly sold debt would be represented by indenture trustees, upon whom the Act imposed significant fiduciary responsibilties.[8]

This case poses the question whether these remedies, adopted by Congress on the recommendation of the SEC, are to be made meaningful by empowering the reorganization trustee to enforce the fiduciary obligations of the indenture trustee.

The enormous value of outstanding debt securities lends added importance to this issue. Between 1961 and 1970, $87 billion worth of debt securities were offered publicly,

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[8] It is noteworthy that both the Chandler Act and the Trust Indenture Act are considered part of the federal scheme of securities regulation. Heuston, Corporate Reorganizations, 38 Col. L. Rev. 1119, 1201-1202 (1938).

$55 billion of this amount was offered between 1967 and 1970, and in 1970 alone the offerings totalled $18 billion. SEC, 36th Annual Report 215 (1970). If reorganization trustees are barred from enforcing the fiduciary responsibilities of indenture trustees, the valuable rights of tens of thousands of debt investors will go unprotected. In order to implement the legislative design to protect the investing public against collusion or wrongdoing by debtors and indenture trustees, reorganization trustees must be afforded standing to enforce the rights of debt investors.

**B. A Reorganization Trustee is Authorized Under the Bankruptcy Laws to Sue an Indenture Trustee for Willful Misconduct or Gross Negligence.**

The Court of Appeals below felt compelled to rule against the Trustee because it was unable to find specific provision in the literal language of the bankruptcy statutes authorizing reorganization trustees to sue indenture trustees (94a). The Court's approach, however, was as wrong as its conclusion.

In the first instance, it is clear that the Bankruptcy Act directly confers standing on reorganization trustees to sue third-party tortfeasors who are culpably implicated in the bankruptcy. Section 187, 11 U.S.C. § 587, gives reorganization trustees "such additional rights and powers as a receiver in equity would have," and in *McCandless* v. *Furlaud*, 296 U.S. 140 (1935), decided before the passage of the Chandler Act, it was established that equity receivers have standing to sue third parties on behalf of bondholders. In *McCandless* the promoters of a corporation and their confederates had purchased bonds issued by the insolvent corporation and then, through the use of fraudulently inflated appraisals of the corporation's assets, resold the bonds to the public at an exorbitant price. The corporation failed, of course, and the Supreme Court, speaking through Mr. Justice Cardozo, held that the receiver in

equity was entitled to sue the promoters to recover their illicit profits for the benefit of bondholders. The substance of the holding is emphasized by the dissent of Mr. Justice Roberts, who felt that the receiver had no standing because the claims were personal to the bondholders. 296 U.S. at 168, 173-174. Since Marine occupies a fiduciary relationship by operation of Congressional enactment rather than under the imprecise principles of general corporate law, it follows *a fortiori* from *McCandless* that the Trustee may sue Marine.

Secondly, even if there were no direct statutory authority, the Trustee would still be empowered to sue Marine, for rights to sue are widely implied under the federal securities laws in order to effectuate the public policies embodied in them. See *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 433 (1964); *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961). Specifically, there can be no doubt that negligence or willful misconduct on the part of an indenture trustee in enforcing or failing to enforce covenants in a trust indenture is actionable under the Trust Indenture Act, for "the disregard of the command of a statute is a wrongful act and a tort." *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946).

In fact, the Second Circuit recently held that the SEC can sue under the Securities Exchange Act of 1934 for restitution of illegal profits for the benefit of defrauded investors, despite the lack of specific statutory authorization. *SEC* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1971), *cert. denied*, — U.S. —, 92 S.Ct. 561 (1971). In so ruling the Court relied upon *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 391 (1970), where this Court emphasized that "[w]e cannot fairly infer from the Securities Exchange Act of 1934 a purpose to circumscribe the courts' power to grant appropriate remedies." See also *Superintendent of Insurance* v. *Bankers Life & Casualty*, — U.S. —, 92 S.Ct. 165, 169 (1971), in which this Court recognized

a private right of action under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Rules and Regulations of the SEC.

The policy of liberally interpreting the remedies of the securities laws was clearly stated in *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 433 (1964), where this Court said, with respect to section 14(a) of the Securities Exchange Act of 1934, "that under the circumstances here it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose. * * * 'And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done.'"

The purpose of the Chandler Act requires that it be given the same broad interpretation. This was properly recognized by the Third Circuit:

> "The tendency of judicial interpretation of the Act has been in the direction of progressive liberalization in respect of the operation of the bankruptcy power so as to meet the challenge of present day economic and business conditions. Continental Illinois National Bank & Trust Co. v. Chicago Rock Island & Pacific Ry. Co., 1935, 294 U.S. 648, 675, 676, 55 S.Ct. 595, 79 L.Ed. 1110. Among the powers granted under the Act are *the collection and distribution of the estates of bankrupts and the determination of controversies in relation thereto.* The bankruptcy court may invoke its equitable powers to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." [emphasis in original] *In re International Power Securities Corporation*, 170 F.2d 399, 402 (3d Cir. 1948).

Against this background it seems clear that the Trustee has an implicit right to assert claims against Marine on behalf of the debenture holders, for the liability of fiduci-

aries under the Trust Indenture Act is unquestionable, and the policy of that statute and the Chandler Act requires that reorganization trustees be permitted to represent debt investors.

Thirdly, the majority below ruled that a claim by debenture holders could not be asserted by a reorganization trustee as a counterclaim to an indenture trustee's account, despite the unqualified statutory power granted by Section 212 of the Bankruptcy Act, 11 U.S.C. § 612, to compel an indenture trustee to account. In so doing the Second Circuit failed to follow the rule established by *In re Solar Mfg. Corp.*, 200 F.2d 327, 331-332 (3rd Cir. 1952), *cert. denied sub nom. Marine Midland Trust Co. v. McGirl*, 345 U.S. 940 (1953), in which the Third Circuit held that the reorganization court could compel an accounting by an indenture trustee and that in such a proceeding the reorganization trustee has standing to counterclaim on behalf of debenture holders for the misconduct of the indenture trustee.

In short, the remedial purposes of the Chandler Act and the Trust Indenture Act can best be effected, in the context of the facts of this case, by this Court's looking to the flexible and realistic approach of the Third Circuit, reflected in *Solar* and *International Power Securities, supra*, rather than the Second Circuit's "niggling" and unrealistic reading of the statutes involved.

### C. As a Practical Matter, Only a Reorganization Trustee Can and Will Adequately Enforce the Rights of Debt Investors.

The reorganization trustee is in a far better position than debt investors to discover, prosecute and prove claims based on the indenture trustee's failure to enforce covenants in the trust indenture. The reorganization trustee has possession of the books and records of the debtor, and, under section 167, 11 U.S.C. § 567, he has the statutory duty

to investigate the affairs of the debtor and report to the court on potential causes of action:

> The trustee . . .
>
> (1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge; [and]. . . .
>
> (3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any cause of action available to the estate.

In making his investigation and report under section 167, the reorganization trustee can retain accountants, lawyers or other professionals, and he has available to him compulsory process for examining witnesses. 11 U.S.C. § 567(2), (4). He functions under the supervision of the reorganization court and with the assistance and participation of the SEC. To be sure, the statutory obligations of the reorganization trustee to investigate the debtor's affairs, and his extraordinary powers and advantages in doing so, place him in the best position to discover the grounds, if any exist, for actions against third parties, and effectively to prosecute all claims based thereon.[7]

By contrast, though individual debt investors are unquestionably entitled to prosecute their own claims, it is doubtful whether they can do so effectively. Not only do they lack access to the debtor's records and power to conduct a meaningful investigation, they also confront the

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[7] Moreover, the reorganization trustee has the benefit of the two-year tolling of the statute of limitations. See section 11(e) of the Bankruptcy Act, 11 U.S.C. § 29(e).

obstacles to effective collective action expressly noted in Section 302(a)(1) of the Trust Indenture Act, 15 U.S.C. § 77bbb(a)(1):

> "... (A) individual action by such investors for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action, and (B) concerted action by such investors in their common interest through representatives of their own selection is impeded by reason of the wide dispersion of such investors through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors;"

Furthermore, in New York and states which follow its law, debenture holders may be barred from bringing class actions and be relegated instead to individual lawsuits, a most ineffective remedy.[8] In addition, not all reorganization proceedings arise in the great financial centers where a sophisticated and aggressive bar may be available to prosecute claims based on intricate corporate manipulations. In smaller communities potential claims of debenture holders are likely to be overlooked or left unchallenged for lack of resources to prosecute them.

Nor do any practical considerations militate against giving the reorganization trustee standing to sue indenture trustees. No significant additional burden on the estate is involved by permitting the reorganization trustee to sue, for he is required in any event to make a full investigation and report of all potential liabilities. Further, when an indenture trustee has acted improperly the estate will

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[8] *Elkind* v. *Chase National Bank*, 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept. 1940), aff'd 284 N.Y. 722, 31 N.E. 2d 198 (1940), held that a class action may not be brought with respect to claims against indenture trustees which do not involve a surrender or release of the trust *res*. Whether *Elkind* is still governing law in New York is presently being litigated in cases arising out of the claims involved in the present case. See note, p. 21, *infra*.

almost invariably have an action against the officers and directors of the debtor for the acts of corporate waste and mismanagement which the indenture trustee wrongfully failed to prevent. Since the underlying facts in such an action will be virtually identical to those asserted against the indenture trustee and the legal issues undoubtedly will overlap, there would be a net savings in time and resources if the reorganization trustee can prosecute both actions. In the particular case at bar, any additional expense involved in permitting the Trustee to sue Marine is minimized by the fact that he must in any event make a full presentation in proving his objections to Marine's proof of claim. Finally, the Trustee would almost surely be allowed to recover counsel fees and expenses if his suit against Marine were successful. *See, e.g., Kahan* v. *Rosenstiel*, 424 F.2d 161 (3d Cir. 1970) *cert. denied, sub. nom. Glen Alden Corp.* v. *Kahan*, 398 U.S. 950 (1970).

No groundless or vexatious litigation will result if reorganization trustees are accorded standing to sue third parties on behalf of debt investors. It is customary in the Southern District of New York to require Chapter X trustees to obtain approval of the reorganization court before actions of any kind are commenced, and this appears to be the general practice. *See* 6 Collier on Bankruptcy 1228 fn. 7, 9. In fact, the possibility of a multiplicity of suits or inconsistent judgments will be minimized by permitting reorganization trustees to sue on behalf of debt investors, and orderly and efficient disposition of what potentially could be a proliferation of litigation will be advanced. *Cf. Penn Central Securities Litigation*, M.D.L. Docket No. 56, E.D. Pa. Dec. 6, 1971, BNA Sec. Reg. & L. Rep., No. 134, p. A-12.

Indeed, under the present unsettled state of the law, debenture holders have commenced several different law-

suits against Marine.[9] If it were clear that reorganization trustees have standing to sue, it is not likely that debt investors would sue either individually or as a class, for in virtually all reorganization cases trustees could be relied upon to prosecute vigorously the claims of all debt investors. Further, there is no reason to suppose that procedures similar to those under Rule 23 of the Federal Rules of Civil Procedure would not be followed with the result that notice would be given to all debt investors, together with the opportunity to exclude themselves from the action. In this event the ultimate resolution of the trustee's action would have a significant *res judicata* effect, whether or not the action were successful on the merits.

Finally, there are simple solutions available should individual debenture holders want to sue in addition to the trustee or should it be impossible to locate all debt investors in order to distribute the proceeds of a favorable judgment. For example, in *SEC* v. *Texas Gulf Sulphur*

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[9] In *Ray* v. *Marine Midland Grace Trust Company*, Supreme Court, New York County, Index No. 2159–1967, an appeal is pending on the question of whether a class action will lie on behalf of the Debtor's debenture holders in light of *Elkind* v. *Chase National Bank*, 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept. 1940), *aff'd* 284 N.Y. 726, 31 N.E. 2d 198 (1940). In *Lewis* v. *Marine Midland Grace Trust Company*, Supreme Court, New York County, N. Y. Law J. p. 12, col. 2, June 28, 1968, the rule of *Elkind* was followed and an action brought on behalf of the Debtor's debenture holders on the same ground as that asserted by the Trustee was dismissed as a class action, although it remains pending with respect to the individual plaintiffs. Subsequently, the same plaintiff brought another suit in federal court on a different theory. *Lewis* v. *Marine Midland Grace Trust Company*, U.S.D.C., S.D.N.Y., Docket No. 68-Civ.-1764. In this action the plaintiff seeks relief under Rule 10b-5 and section 10(b) of the Securities Exchange Act of 1934 with respect to the facts involved in the instant case. Whether a Rule 10b-5 action can be maintained is open to question, and even if the complaint is upheld the question will remain whether all, or merely some, of the debenture holders will benefit from any judgment ultimately recovered.

*Co.*, 312 F. Supp. 77 (S.D.N.Y. 1970) *affirmed* 446 F.2d 1301 (2d Cir. 1971), *cert. denied* — U.S. —, 92 S. Ct. 561 (1971), where the SEC was permitted to sue on behalf of investors, the defendants were ordered to make restitution of their illegal profits. This money was placed in an interest-bearing escrow account for five years subject to disposition by the court. Injured investors are to be compensated out of this fund and any private judgments independently obtained are likewise to be satisfied out of it. At the end of five years any undistributed money will become the property of the company.

To summarize, this Court long ago established that equity receivers have standing to sue third parties on behalf of debt investors. Reorganization trustees have all the powers of equity receivers, and recognizing the standing of reorganization trustees serves the explicit purpose of the Chandler Act of making them representatives of investors as well as creditors. An indenture trustee is unquestionably liable under the Trust Indenture Act for malfeasance that injures debt investors, and there is ample precedent for implying rights to sue under federal statutes regulating publicly-held securities. Further, the reorganization trustee is in a unique position to discover the claims of debt investors and to enforce them vigorously and expeditiously, and all significant practical considerations militate in favor of giving him standing. Unless this Court reverses the decision below, however, and recognizes the standing of reorganization trustees to litigate claims arising out of and relating to reorganizations, the rights of debt investors will continue to receive tardy and inadequate enforcement.

### D. Neither Reason Nor Precedent Supports the Narrow and Hypertechnical Position of the Court Below.

The Second Circuit ruled that the Trustee lacks standing to sue Marine on behalf of the debenture holders because the action does not involve property of the Debtor and

because the lawsuit would not affect the plan of reorganization. The conclusion that some "*res*" must be involved is neither sound nor rational, and the conclusion that the plan of reorganization would not be affected is simply wrong.

In *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (2d Cir. 1943), Judge Augustus Hand conceded that a reorganization trustee could sue an indenture trustee on behalf of debenture holders where the debentures had been secured by property of the debtor, even if the security was worth less than the debt or had been conveyed away. He contended that the result was different, though, where the debentures were unsecured, for then the claims "are personal to the debenture holders and have no place in the plan of reorganization." 137 F. 2d at 800. Judge Learned Hand dissented, for he saw no rational distinction between a case where an indenture trustee, in dereliction of his fiduciary obligation, conveys away the security and one in which, by similar misfeasance, he permits the debtor to siphon off assets which should have remained available to pay off the debentures. "In what way," he demanded, "does that differ from allowing a debtor, in violation of the mortgage, to substitute improper collateral?" *Id.* at 802.

Twenty-eight years later, the Court below supplied this answer: "The answer [is] that in the latter case the mortgage trustee would have dealt improperly with property of the bankrupt." (88a) A proper response to Judge Learned Hand, however, would have answered his question instead of begging it.

The standing of a trustee in reorganization, and ultimately the practical likelihood that the rights of debt investors will be adequately enforced, should not depend upon irrelevant technicalities of property law. If "property" were permitted to be the decisive factor, then niceties of state law would determine the course of proceedings in which a nationwide federal doctrine is peculiarly necessary. The effect on debenture holders is the same whether

the misfeasance of the indenture trustee permitted the debtor to substitute worthless assets for the property pledged to secure the debt or permitted the debtor to squander its assets in violation of the trust indenture. What is fundamental in either case is that the indenture trustee has breached its fiduciary duty to debt investors and that adequate redress can be obtained only if the reorganization trustee is empowered to act.

It has been more than fifty years since Dean Pound observed that, "Wealth, in a commercial age, is made up largely of promises." Pound, Introduction to The Philosophy of Law 113 (Rev. Ed. 1954). Whether debt is secured or unsecured, the basic protection of debt investors lies in the integrity and vigilance of the indenture trustee. The Trust Indenture Act recognized this by imposing inescapable fiduciary obligations on the indenture trustee. Those duties will become practical realities only when the reorganization trustee is authorized to enforce them. It makes no sense instead to rule that the fiduciary promises of an indenture trustee can be counted on only when they can be linked, whether meaningfully or not, to some talismanic *"res"*.

The inadequacy of dependence upon property concepts is demonstrated by the discussion in the opinion below of the decision in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F. 2d 555 (2nd Cir. 1953), *cert. denied* 346 U.S. 835 (1953), which, as Judge Kaufman observed, announced the demise of the *Clarke* rule (96a). In *Prudence-Bonds* it was contended that the indenture trustee had negligently failed to enforce a promise by a third party to pay the mortgages which secured the debt if the mortgagors defaulted. Judge Learned Hand, speaking for himself and Judges Swan and Frank, found that the broad authority of the reorganization court to implement a reorganization plan furnished ample basis for permitting suit against the indenture trustee. The majority below did not concede, however, that *Prudence-*

*Bonds* was inconsistent with *Clarke*, and gave this reason (91a):

> "The difference between failure to enforce a third party's guaranty of a mortgage assigned to an indenture trustee or other property held by it as security and failure to enforce a promise by the debtor is the highly significant one that the former has diminished the debtor's estate and the latter has not."

That analysis, however, is a *non sequitur*. The third party's guarantee in *Prudence-Bonds* may have been part of the trust *res*, but only by an agonizing stretch of imagination could it be deemed property of the debtor. The failure of the indenture trustee to enforce that guarantee had a drastic effect on the value of the bondholder's security, but made not the slightest dent in the debtor's estate.

If the question involved determining what constitutes the "property" of the debtor, it may be sound, as the Court below suggests, to view the promise to the bondholders by a third-party guarantor as "property" of the Debtor, whereas it would make little sense so to denominate a promise by the Debtor itself. But such sleight-of-hand only puts emphasis on creating (or demolishing) novel concepts of property, and has no reasonable relationship to the role of reorganization under Chapter X. The question at hand is not how elastic we should make our notion of a debtor's "property," but whether the reorganization trustee should be allowed to sue the indenture trustee. If he may sue the indenture trustee for negligently failing to enforce the promise of a third-party guarantor, may he not also sue for negligently failing to enforce the promise of the Debtor?[10] In either case there is a promise rather than "property" in any strict sense, and the cause of the loss to the debt investors is the indenture trustee's negligent failure to enforce a promise.

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[10] Even the majority below recognized that the debtor's own wrongdoing does not work an estoppel in an action by a reorganization trustee (89a). *McCandless* v. *Furlaud*, 296 U.S. 140 (1935).

Similarly subject to criticism is the summary rejection by the Court below of the decision in *In re Solar Mfg. Corp.*, 200 F.2d 327 (3rd Cir. 1952), *cert. denied sub nom. Marine Midland Trust Co.* v. *McGirl*, 345 U.S. 940 (1953) (89a, n. 4). The Third Circuit in *Solar* permitted a reorganization trustee to counterclaim against an indenture trustee's account because the latter had failed to observe a covenant requiring it to earmark proceeds for the benefit of debenture holders should any of the debtor's major assets be sold. Again, as here, the ground for permitting the reorganization trustee to sue lay in wrongful breach of promise by the indenture trustee rather than in any mishandling of "property" pledged to secure the debt. *Solar*, in fact, is flatly inconsistent with the decision below, and really cannot be harmonized with *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943). Clearly *Solar*, and not *Clarke*, states the preferable rule.

Standing may inevitably be one of those legal issues which cannot be wholly freed from technicalities, but there is no need to plunge purposely into subleties which would elude a scholastic metaphysician. As Judge Kaufman pointed out, when a line of analysis "is seen to yield such awkward conclusions, it is perhaps better to re-examine the hypothesis than to ascribe to Congress an intent to fashion so irrational a design." (98a). The hypothesis which needs re-examination here is the notion that the propriety of permitting a reorganization trustee to sue an indenture trustee on behalf of debt investors should depend upon the whereabouts of the debtor's "property."

Turning to the question of whether the Trustee's suit against Marine would affect the plan of reorganization, the Court below was simply wrong to conclude that it would not. If the Trustee recovered the full face value of the debentures for the debenture holders, they would be paid off dollar for dollar, whereas from the estate itself they would get far less. Even if, as the majority below contended,

other general creditors would not be benefited because Marine would be subrogated to the rights of the debenture holders (92a), the Trustee's action would still be authorized. Since the debenture holders here are unsecured, they stand as mere general creditors and if someone else is subrogated to their rights it deprives other general creditors of nothing. On the other hand, the debenture holders would receive full value, and any action by a reorganization trustee which benefits the creditors in aggregate is clearly within his powers and duties. In fact, most actions prosecuted by a reorganization trustee benefit only a limited group, so it can be no criticism of the Trustee's suit that it would benefit debenture holders without harming other creditors. *Cf. In re Central States Electric Corp.*, 143 F.2d 684 (4th Cir. 1944).

Here, however, all general creditors would benefit if the Trustee prevailed in full against Marine, for Marine would not be permitted to subrogate. The majority below contended that if the Trustee prevailed, "Marine would simply be substituted for the debenture holders as the claimant" (92a), citing as the sole authority section 141 of the Restatement of Security (1941). That section, however, governs only the right of a *surety* to be subrogated to the rights of a debtor if he pays the debt. Unlike a surety or guarantor, an indenture trustee is not obligated in the first instance to make good on debentures if the debtor defaults. It will become liable to do so only by reason of its own wrongful breach of fiduciary duty. Rather than being entitled to subrogation under the principles of surety law, Marine would have to seek subrogation under the general equitable doctrine enunciated in section 162 of the Restatement of Restitution (1937):

> "Where property of one person is used in discharging an obligation owed by another or a lien upon the property of another, under such circumstances that the other would be unjustly enriched by the retention of the benefit thus conferred, the for-

> mer is entitled to be subrogated to the position of the obligee or lien-holder."

The question, in short, would be whether an indenture trustee found culpably responsible for the default on debentures is entitled to subrogation with respect to money which would otherwise go to innocent general creditors, on the ground that paying the money to them rather than him would constitute unjust enrichment. The statement of the proposition is its own refutation. It is settled law that negligent conduct will bar a party from subrogation. *A. Gusmer, Inc.* v. *McGrath*, 196 F.2d 860 (D.C. Cir. 1952); *see German Bank* v. *United States*, 148 U.S. 573 (1893). Further, subrogation will be allowed only where the equities of the party seeking subrogation are superior to those of the party against whom the right is asserted. *Bank of Fort Mill* v. *Lawyers Title Ins. Corp.*, 268 F.2d 313, 315 (4th Cir. 1959); *United States Fidelity & Guaranty Co.* v. *First National Bank in Dallas*, 172 F. 2d 258, 263 (5th Cir. 1949). Subrogation will not be allowed where the liability of the party claiming subrogation arises from a wholly different source than that of the primary obligor, *Meyers* v. *Bank of America*, 11 Col. 2d 92, 77 P.2d 1084, 1089 (1938), and subrogation will be denied when the claiming party is guilty of wrongful or unconscionable conduct. *American Surety Company* v. *Bethlehem National Bank*, 314 U.S. 314 (1941); *Lawrence Warehouse Co.* v. *Menary*, 143 F. Supp. 883 (S.D. Iowa 1956); *Standard Accidental Ins. Co.* v. *Pellecchia*, 15 N.J. 162, 104 A.2d 288, 302 (1954). Nor, finally, would Marine be entitled to reimbursement from the debtor under any theory of indemnification. *Ingham* v. *Eastern Airlines, Inc.*, 373 F.2d 227 (2d Cir. 1966), *cert. denied, sub. nom. United States* v. *Ingham*, 389 U.S. 931 (1967); *Globus* v. *Law Research Services, Inc.*, 418 F.2d 1276 (2d Cir. 1969) *cert. denied*, — U.S. — (1970); *State Mutual Life Assurance Co.* v. *Peat, Marwick, Mitchell & Co.*, 49 F.R.D. 202 (S.D.N.Y. 1969).

The last reason advanced by the Court of Appeals majority for concluding that it would not affect the plan

of reorganization to permit the Trustee to sue Marine was that the claim against Marine could not be prosecuted to judgment until the results of the reorganization were known, for otherwise the actual loss suffered by debenture holders could not be ascertained.

It is unreasonable to assume that whatever indeterminateness may be involved in a reorganization ought to be borne by innocent debt investors rather than by the indenture trustee who has been guilty of misfeasance. Such an approach would delay for many years the prosecution of claims against the indenture trustee. The problems of uncertainty of damages should not be borne by the innocent debenture holders, but should be resolved in the manner suggested by Judge Frank in *President and Directors of Manhattan Co.* v. *Kelby*, 147 F.2d 465, 476 (2d Cir. 1944), *cert. denied* 324 U.S. 866 (1945):

> "This case is governed by the rule that, where one has committed a wrong which renders impossible the exact ascertainment of damages, 'the risk of the uncertainty should be thrown upon the wrongdoer instead of upon the injured party. * * *' Story Parchment Co. v. Paterson Parchment Co., 282 U.S. 555, 563, 51 S. Ct. 248, 251, 75 L. Ed. 544. We recently held that rule applicable to a wrongdoing trustee. York v. Guaranty Trust Company, 143 F.2d 503, 517. We should not indulge in conjectures to lighten the burdens of such a trustee at the expense of its beneficiaries."

Finally, the question whether it will substantially affect plans of reorganization to permit reorganization trustees to sue on behalf of debt investors is an intensely practical question to which a pragmatic, rather than a theoretical, answer must be provided. Judge Kaufman, dissenting below, put the point forcefully (99a-100a):

> "Although the bondholders' recovery [may] swell directly only the purses of the bondholders, the

majority ignores the central consideration that certainty as to the bondholders' rights against the indenture trustee cannot fail to affect the views of the interested parties and the court in passing on the fairness of the reorganization plan. 11 U.S.C. § 621(2). The majority thus seems to misconstrue the true scope and nature of a reorganization proceeding. The process of reorganizing is not performed merely by a nice, sharp, precise and mathematical apportionment of a debtor's estate according to fixed formulas.

Rather, the objective is carried out through a process of negotiation, and some give-and-take, in an attempt to adjust equitably and with sensitivity to the nuances of the individual case the rights of competing interested parties. As Judge L. Hand argued persuasively in dissenting from the decision in *Clarke*, the reorganization court has jurisdiction over a case such as this as part of its obligation to 'adjust the mutual rights of the debtor's creditors as between themselves.' 137 F.2d at 802. I see no reason for denying to the reorganization court, as the majority does, the power to discharge this obligation here or properly to perform its duty to adjudge the equitableness of a proposed reorganization plan."

In short, a plan of reorganization can be affected in many ways, some of which are susceptible to fine, theoretical analysis but many of which are not. For instance, an indenture trustee might well waive its asserted right to subrogation and the debenture holders, in consideration of a substantial payment from the indenture trustee, might well withdraw their claims, making possible a larger distribution to the other unsecured creditors. Such adjustment of rights is the essence of reorganization under Chapter X, as is evidenced by two recent proceedings. In *In re Continental Vending Machine Corp.*, E.D.N.Y. 63-B-663, the reorganization trustee negotiated a settlement under which the indenture trustee waived its priority over debenture holders who otherwise would have received

nothing from the estate, but who had a colorable cause of action against the indenture trustee. See SEC, 36th Annual Report 187 (1970). Without this settlement the debenture holders might have successfully opposed any plan and forced the debtor into straight bankruptcy.

A somewhat similar result was reached in *In re Dilbert's Leasing & Development Corp.*, E.D.N.Y. 63-B-148, where the reorganization trustee settled litigation commenced on behalf of debenture holders against the indenture trustee. The result was the creation of a fund for the benefit of the debenture holders which reduced their claims against the estate.

The Court of Appeals erroneously concluded that the question of the standing of a reorganization trustee to represent a debt investor depends upon the technicalities governing whether particular interests of the debtor constitute "property" or not. Further, the Court wrongly decided that it would not affect the plan of reorganization if the Trustee were successful in his litigation against Marine. Finally, the Court failed to appreciate the practical dynamics of bankruptcy reorganization, for it is indubitable that permitting the reorganization trustee to pursue all claims arising out of the bankruptcy will significantly enhance his ability to negotiate or compel the fairest and most equitable arrangement for all parties.[11]

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[11] *Continental Vending* and *Dilbert's, supra*, also exemplify the appropriateness of including recoveries on behalf of bondholders in a plan of reorganization. Although the Court below was of the view that Section 216 of the Bankruptcy Act, 11 U.S.C. § 616, contained no "rubrics" under which such matters could be included in a plan of reorganization, it overlooked Section 216(14) of the Act, 11 U.S.C. § 616(14) which indicates that a plan of reorganization

> ". . . may include any other appropriate provisions not inconsistent with the provisions of this chapter."

## POINT II

**The Trustee in reorganization is a real party in interest with respect to claims against an Indenture Trustee brought on behalf of debenture holders.**

Rule 17(a) of the Federal Rules of Civil Procedure states that "every action shall be prosecuted in the name of the real party in interest," and that provision is made applicable in reorganization proceedings by General Order in Bankruptcy 37. In *Clarke* v. *Chase National Bank*, 137 F.2d 797, 801 (2d Cir. 1943), the Second Circuit cited this rule as an additional reason for not permitting a reorganization trustee to sue on behalf of debenture holders, and the majority below reiterated that view in this case (93a). This interpretation of the real-party-in-interest requirement is without support in reason, history, or precedent.

First, the Trustee is a real party in interest because it is part of his statutory duty to bring suits such as this one. It is, of course, the statutory duty of a reorganization trustee to represent all creditors, and if the Trustee is successful in his claim against Marine, the debenture holders will benefit. Moreover, if subrogation were denied to Marine, as in equity it ought to be, the other general creditors would directly benefit as well. Thus, success by the Trustee against Marine would benefit the general creditors in aggregate. Since an act performed by the Trustee which would, if successful, benefit creditors is one performed in the discharge of his statutory duty, it seems beyond question that he is acting as a real party in interest. There simply is no requirement that all acts of a reorganization trustee benefit creditors equally, nor can it conceivably be argued that a party discharging a statutory duty is not a real party in interest.

Not only is it demonstrable that the Trustee's action against Marine is one taken by the real party in interest because it is done in discharge of the Trustee's statutory

duty, but it is further clear that the same factors which determine whether the Trustee has standing to sue Marine are dispositive of the question under Rule 17(a). *United Federation of Postal Clerks AFL-CIO* v. *Watson*, 409 F. 2d 462, 470 (D.C. Cir. 1969). See also *Smith* v. *Board of Education*, 365 F. 2d 770, 777 (8th Cir. 1966) (Blackmun J.). Since, as the prior portion of this brief has shown, the Trustee unquestionably has standing to sue Marine, it follows that he meets the requirements of Rule 17(a).

Any contrary conclusion defies the history and purpose of Rule 17(a). The real party in interest requirement first appeared in New York in David Dudley Field's Civil Code of 1848. According to Professor Atkinson, "The Real Party in Interest Rule: A Plea for its Abolition," 32 N.Y.U.L. Rev. 926, 934-935 (1957), its original purpose was to permit suits at law by assignees of choses in action. As stated in the notes of the Advisory Committee on Rules for Civil Procedure:[12]

> "In its origin the rule concerning the real party-in-interest was permissive in purpose: it is designed to *allow* an assignee to sue in his own name. That having been accomplished, the modern function of the rule in its negative aspect is simply to protect the defendant against a subsequent action by the party actually entitled to recover, and to insure generally that the judgment will have its proper effect as res judicata."

In short, the real party in interest rule was adopted to liberalize practice not restrict it. *See Kilbourn* v. *Western Surety Co.*, 187 F. 2d 567, 571 (10th Cir. 1951). It never was intended to be used to bar suits brought to effectuate Congressional statutory policy or for the benefit of a large number of widely scattered investors. In fact, the rule has been abolished in New York, the state of its origin, in part because "it misleadingly seemed to say that the action must be brought by the party to be benefited." 2 Weinstein, Korn & Miller, New York Civil Practice ¶ 1004.01.

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[12] 3A Moore's Federal Practice, ¶17.01 [8] (2d ed. 1970).

In sum, the Trustee is a real party in interest because suit against Marine is brought pursuant to his statutory obligation. Further, the fact that he is a real party in interest flows necessarily from the conclusion that he has standing to sue on behalf of debt investors. Finally, the affirmative purpose behind the real party in interest requirement was solved long ago by other procedural innovations, and the negative purpose of guarding against improper *res judicata* effect has nothing to do with the present action. The Second Circuit, in short, has simply misunderstood and misused Rule 17(a).

## CONCLUSION

**For the reasons stated, the judgment of the Court of Appeals should be reversed and the cause remanded to the District Court.**

Respectfully submitted,

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# APPENDIX A

## Statutes Involved

Chapter X of The Bankruptcy Act, 11 U.S.C. § 501 *et seq.*, provides in pertinent part:

§ 167, 11 U.S.C. § 567. *Powers and duties; trustee*

The trustee upon his appointment and qualification—

(1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;

(2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;

(3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;

* * *

§ 187, 11 U.S.C. § 587. *Same; rights, powers and duties*

Where not inconsistent with the provisions of this chapter, a trustee, upon his appointment and qualification, shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 72 of this title, and, if authorized by the judge, shall have and may exercise such additional rights and powers

as a receiver in equity would have if appointed by a court of the United States for the property of the debtor.

§ 212, 11 U.S.C. § 612. *Same; regulation by court*

"The judge may examine and disregard any provision of a * * * trust indenture * * * or other authorization, by the terms of which an agent, attorney, indenture trustee, or committee purports to represent any creditor or stockholder, may enforce an accounting thereunder * * *."

§ 216, 11 U.S.C. § 616. *Provisions of plan*

A plan of reorganization under this chapter—

* * *

(14) may include any other appropriate provisions not inconsistent with the provisions of this chapter.

The Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa *et seq.*, provides in pertinent part:

§ 77bbb. Necessity for regulation

(a) Upon the basis of facts disclosed by the reports of the Securities and Exchange Commission made to the Congress pursuant to section 78jj of this title and otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors in notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, which are offered to the public, are adversely affected—

(1) when the obligor fails to provide a trustee to protect and enforce the rights and to represent the interests of such investors, notwithstanding the fact that (A) individual action by

such investors for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action, and (B) concerted action by such investors in their common interest through representatives of their own selection is impeded by reason of the wide dispersion of such investors through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors;

(2) when the trustee does not have adequate rights and powers, or adequate duties and responsibilities, in connection with matters relating to the protection and enforcement of the rights of such investors; when, notwithstanding the obstacles to concerted action by such investors, and the general and reasonable assumption by such investors that the trustee is under an affirmative duty to take action for the protection and enforcement of their rights, trust indentures (A) generally provide that the trustee shall be under no duty to take any such action, even in the event of default, unless it receives notice of default, demand for action, and indemnity, from the holders of substantial percentages of the securities outstanding thereunder, and (B) generally relieve the trustee from liability even for its own negligent action or failure to act;

(b) Practices of the character above enumerated have existed to such an extent that, unless regulated, the public offering of notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, by the use of means and instruments of transportation and communication in

interstate commerce and of the mails, is injurious to the capital markets, to investors, and to the general public; and it is declared to be the policy of this subchapter, in accordance with which policy all the provisions of this subchapter shall be interpreted, to meet the problems and eliminate the practices, enumerated in this section, connected with such public offerings.

* * *

§ 77ooo. Duties and responsibility of the trustee—

Duties prior to default

(a) The indenture to be qualified may provide that, prior to default (as such term is defined in such indenture)—

(1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture; and

(2) the indenture trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture;

but such indenture shall contain provisions requiring the indenture trustee to examine the evidence furnished to it pursuant to section 77nnn of this title to determine whether or not such evidence conforms to the requirements of the indenture.

* * *

Responsibility of the Trustee

(d) The indenture to be qualified shall not contain any provisions relieving the indenture trustee

from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct, except that—

(1) such indenture may contain the provisions authorized by paragraphs (1) and (2) of subsection (a) of this section;

(2) such indenture may contain provisions protecting the indenture trustee from liability for any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be proved that such trustee was negligent in ascertaining the pertinent facts; and

* * *

§ 77vvv. Court review of orders; jurisdiction of offenses and suits

* * *

(b) Jurisdiction of offenses and violations under, and jurisdiction and venue of suits and actions brought to enforce any liability created by, this subchapter, or any rules or regulations or orders prescribed under the authority thereof, shall be as provided in section 77v(a) of this title.

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